The Role of Distressed Investing and Hedge Funds in Turnarounds and Buyouts And How This Affects Middle-Market Companies

By Jay Krasoff and John O'Neill

Stories of distressed investing can be traced back in history to the moneychangers in the Bible, who were able to arbitrage the value of the half shekel in Jewish temples[1]. European moneychanger Nathan Rothschild used his superior access to information about the Battle of Waterloo to manipulate British currency and increase his vast fortune by a multiple of 20 times overnight[2]. “Under-the-radar” specialized traders became active in the post-Depression era of the 1930s, while little-known hedge funds actively traded in distressed paper in the 1960s. Now, in the latest step in the evolution of distressed investing, credit-oriented hedge funds have become much more proactive in the distressed investing market and the accompanying restructuring process. Those who operate middle-market companies should be aware of this new challenge, which can make much-needed funds available quickly…but at a price.

INSTITUTIONAL INVESTORS

Historically, banks, with the highest-ranking debt in a given distressed company, and the most to lose; were able to control the restructuring process when credit became distressed. During the past five years, however, institutional investors have become a significant component of the leveraged finance market in the U.S. These lenders are primarily insurance funds, prime rate funds, and collateralized loan obligations (CLOs), with the last being the dominant participant. Searching for increased yield, these lenders have changed their lending focus from the more competitive large leveraged buyouts and acquisition financings to the middle market, with literally hundreds of billions of dollars of lending capacity specifically targeted on this area. These institutional lenders are most often investing in Term B bank debt, second lien financing and corporate bonds. Today, the Term B part of a senior bank credit, in a typical leveraged loan of any size, can dwarf the Term A and revolver. With the recent proliferation of second lien paper, both as rescue financing and in originally syndicated debt capital structures, these institutional investors have effectively become the creditors with the most to lose in a restructuring.

Consequently, it is not surprising that institutional lenders have now become much more proactive in the restructuring process and the distressed investing market. In addition, many of the CLOs investing in this paper are controlled by hedge funds that also have a distressed investing strategy, a group that Fitch Ratings, Ltd. refers to as "credit-oriented hedge funds." Credit-oriented hedge fund investments can become self-fulfilling as part of a pre-planned distressed private equity play, a possibility of which middle-market companies and private equity sponsors should be very aware.

RISE OF DISTRESSED INVESTING

To some degree, the rise of distressed investing can be traced back to the corporate raiders of the 1980s,[3] most of whom were wealthy individuals pooling other investors' money within hedge funds. Hedge funds are similar to mutual funds, but exempt from SEC rules as private investment vehicles only offered to wealthy, sophisticated, "accredited" investors. Today, different hedge funds invest across a multiple of strategies, a key one of which is "distressed." Distressed investing has only recently been considered a legitimate investment class, due primarily to the credit bubble of 1997-2001 and the proliferation of hedge funds and structured debt vehicles such as collateralized bond obligations (CBOs) and CLOs. CBOs and CLOs are special-purpose vehicles that package a portfolio of bonds or loans and sell the funding into the securitization market in different risk tranches. In the bank finance world, CLOs are the largest participant in the class of institutional lenders. Credit-oriented hedge funds typically make leveraged investments in subordinated and equity tranches in a CLO securitization funding. To the extent that these hedge funds also have a distressed investment strategy, they may have an advantage in the form of an early warning signal for potential distressed investment opportunities.

Historically, distressed investing opportunities in the U.S. have primarily been in large companies, which were most likely to have bonds and/or tradable senior debt (though the latter traded, until recently, in a relatively inefficient secondary market). More recently, with the emergence of the institutional lenders in the leveraged finance world and the need to improve spread in a sellers' market, many of these distressed investors are now focusing on transactions in the middle market.

The key characteristics that traditionally separated good distressed investors from the rest of the market were a strong contrarian viewpoint and a willingness to get actively involved in situations and transactions that the typical investor would avoid. Because of the highly competitive nature of this industry today, "proprietary deal flow" should now also be added as a key ingredient for success. Like Nathan Rothschild, distressed investing today often involves an arbitrage play making use of superior knowledge of a particular situation.

Modern distressed investing, at its most fundamental level, is primarily an arbitrage play, involving stakeholders who have become fatigued after management teams continually miss financial projections and covenants. Bank regulators will often pressure banks to take larger reserves against possible losses in these types of situations, making most leveraged loans quickly uneconomical from a bank accounting perspective. This creates a market where the regulated banks likely to be sellers of distressed bank debt, giving rise to the potential arbitrage play for the distressed investor. If a distressed investor is already indirectly involved in a bank group, he may have a significant advantage in knowing which lenders are becoming fatigued, and when.

THE PRECEDENT

The current era of distressed investing went mainstream in 2001 with the purchase of Regal Cinemas by an investor group led Oaktree Capital and Phillip Anshutz. Although not a middle-market transaction, this wrote the playbook for countless middle-market distressed investing plays that followed. Two storied private equity funds, KKR and Hicks Muse Tate and Furst, were outstrategized by a team of distressed investors and lost control of a combined $1 billion equity investment.

Once Regal became distressed, KKR and Hicks Muse were limited in what they could legally and realistically do to protect their investment. Oaktree and Anshutz, the distressed investors, were better able to act on their understanding of Regal's enterprise value relative to how the debt markets valued the firm in late 2000 and early 2001. By buying the majority of the firm's senior bank debt (at a discount), the distressed investors were able to control the eventual restructuring process, and purchase the firm's bond debt for less than 25 cents on the dollar. This bond debt became the "fulcrum security" that was then converted into equity in a prepackaged bankruptcy. This type of transaction became known as a "loan-to-own" play or an "involuntary private equity" investment.

In approximately 18 months, the distressed investors were able to buy $1.8 billion of debt for roughly $800 million and put the company into a pre-packaged bankruptcy to, among other things, deal with holdouts in the debt capital structure. Then, they issued high-yield bonds in bankruptcy as part of the exit financing. When Regal exited bankruptcy with $500 million of new bank debt, Oaktree and Anshutz merged the company with Anshutz's investment in United Artists and sold 22% of the combined companies in a $342 million public equity offering. This gave the distressed investors all of their original investment back, along with 78 percent ownership of a company that had a market capitalization of $2.8 billion and was generating $250 million of annual EBITDA. Within 13 months of the IPO, the company also paid special dividends totaling $715 million to its Class A and B shareholders. This chain of events became the grand slam of distressed investments.

TYPICAL LOAN-TO-OWN INVESTMENT

The steps for setting up a typical "loan-to-own" investment are relatively simple, and apply just as easily to middle-market transactions. First, the investor buys control of the capital structure, which usually involves buying the fulcrum security – the highest class of claim that is expected to be, at least, partially impaired in a bankruptcy – at a significant discount. Then, additional senior credit can be structured for a turnaround plan or, more likely, for rescue financing and/or a DIP financing. This ensures that any additional collateral is pledged to the new lenders. The new financing will have stringent loan covenants, in order to keep the process moving smoothly. Typically, after a 90-day-plus preference period, the company will file for bankruptcy. In the best case, this will be a prepackaged filing and will involve a debt for equity swap that will transfer ownership of the company to the distressed investor. The distressed investor can immediately recapitalize the company with new debt, post-bankruptcy, which may allow it to recover a substantial portion, if not all, of its original investment, and own a controlling interest in the firm's new equity as well.

In a perfect case, the new owners would have a zero-cost equity investment, and would take control of a company for significantly less than what a strategic buyer or private equity firm might have to pay in a typical auction process. Another variation on the theme includes having the distressed investor also providing the exit financing, cornering the lucrative arrangement and syndication fees available that would normally go to a large agent bank. Some examples of these transactions in the middle market include:

- ***Rand McNally***. Mapping firm Rand McNally had a high level of brand-name recognition, but also a high level of debt, when it hired Deutsche Bank Alex Brown in 2001 to find a buyer. In early 2002, Leonard Green & Partners, L.P. started buying Rand McNally bank debt for almost 60 cents on the dollar. By early 2003, Leonard Green owned 60 percent of the company's $215 million in bank debt. In February 2003, Rand McNally agreed to file a pre-packaged bankruptcy, in which agreed to file a pre-packaged bankruptcy in which $215 million of senior secured debt would be exchanged for a $100 million senior term loan and all of the equity. The banks received a 46% recovery (via $12 million cash and the new term loan) and 90% of the equity; bondholders holding $100MM in notes received 10% of the equity. Leonard Green ended up with 54 percent of the reorganized equity, while previous private equity owner AEA Investors Inc. lost over $125 million in invested capital.

- ***Moll Industries***. Plastic injection molding roll-up Moll Industries had 2000 revenue of $343 million and EBIDTA of $34 million. Pre-bankruptcy, the company's capital structure consisted of $68 million in senior bank debt, $5 million of mortgage debt and $82 million of unsecured and sub notes. Highland Capital started to buy the sub notes, and then moved into buying Moll's bank debt at a discount. By the end of 2001, Moll's EBIDTA was negative $6 million. Though the company sold a number of divisions and bought bonds at various discounts up to 65 percent in an attempt to regain its footing, a number of refinancing attempts failed. In June 2002, Highland acquired 81 percent of Moll's bank debt and provided additional liquidity advances to help keep the company out of bankruptcy. However, in September 2002, when Moll was actively pursuing an out-of-court restructuring, three funds controlled by Highland filed an involuntary bankruptcy petition for the company. Highland pushed through a plan exchanging $35.5 million of mezzanine debt for a new $24 million, five-year mezzanine loan (five percent cash, three percent PIK) and 90 percent of Moll's equity. Highland also provided senior exit financing of a $15 million unfunded revolver (prime rate plus two percent) and a $35 million term loan (seven percent).

- ***All Star Gas.*** A retail propane gas distributor with operations in the Midwest and Rocky Mountain states, All Star Gas suffered from years of undercapitalization, an inability to hedge, a poorly executed rollup of other companies and management's failure to curb expenses. The company had about $80 million in senior bond debt, another $5 million in multiple subsidiary debt for various pieces of equipment and certain isolated receivables, approximately $8 million in unsecured vendor payables and a subordinated debenture for about $12 million at the beginning of 2003. Two distressed debt funds led by a Morgan Stanley fund actively sought the purchase of the senior bond debt at a substantial discount, leaving the funds in control of 75 to 80 percent of those bonds at the beginning of 2003. At that time, All Star Gas was extremely tight on cash and was losing the ability to serve its customers. The company needed an emergency loan to tide it over until September, when its revenue and profits would begin their usual seasonal increase. The senior notes buyers provided the rescue financing…but with extremely tight controls requiring that those in management assign all of their controlling stock to a voting trust controlled by the senior lending group, which would then assume control in the case of a default. Within a month, there was a default. The voting trust called a shareholders meeting at which a new board of directors – composed of the distressed debt purchasers – was elected. The new board fired

the existing management and appointed representatives from Corporate Revitalization Partners to serve as the turnaround management team. The funds secured additional financing from the distressed debt holders, pledging all of the remaining company assets. The company filed for Chapter 11 bankruptcy in July 2003 and was subsequently reorganized with the distressed debt holders purchasing the remaining senior notes at a discount, converting these notes to the equity class, originating a new $10.0 million revolving line of credit and paying the unsecured creditors a dividend.

PROPRIETARY DEAL FLOW

As previously stated, credit-oriented hedge funds have become more active in middle-market distressed situations. This phenomenon is tied to the potential "proprietary deal flow" in distressed investments that can be captured in the CLO portfolio. Often it is the first investor to move that can control the restructuring process and block out other possible participants. With so much liquidity in the market today, these funds can create multiple CLOs, invest in a significant amount of the new leveraged transactions each year and essentially use the CLO portfolios as an incubator for future distressed investment plays.

The trend in credit-oriented hedge fund involvement in middle-market distress has also been driven by the convergence of high-yield rates and leveraged bank structure rates, fueled by interest rates reaching historical lows during this period. This has allowed CLOs to crowd out the bond funds in the typical leveraged capital structure. Put differently, the premium for having an unsecured position in the capital structure is no longer as appealing as it had been in previous rate environments. At first, it was Term Loan B senior secured debt (minimally amortizing senior term loans), which became the largest piece of the leveraged loan market. These were loans that regulated banks tended to avoid, as the lack of amortization was perceived as a weakness by the bank examiners. Soon, CLOs also began investing in second lien facilities that were structurally similar to Term Loan B tranches, but with a second lien on the assets behind the senior secured lenders. Here there was more risk, but less than with unsecured credit, and the returns were significantly better than those from bank debt.

It is not hard to imagine a hedge fund being able to use the information gained from its CLO investments to gain a competitive advantage relative to timing and value of impending distressed investments, through loan covenants and periodic bank reporting requirements. Although there are rules about creditors with access to inside information trading in a company's debt, much of today's distressed debt trades under "big boy letters," agreements whereby a buyer or seller of a security or loan agrees not to sue an insider on the other side of the transaction based on information not disclosed by said insider. Thus, access to "private" bank reporting information, combined with exposure to signs of individual bank fatigue at bank meetings, can theoretically give institutional lenders a huge advantage over traditional third-party distressed investors. This creates room for a classic arbitrage play.

Again, the key criterion is proprietary deal flow. The distressed investor is willing to give up some of the return by already owning some of the debt at par, in order to avoid an auction, or fighting for, and potentially losing, the distressed investment opportunity. By buying into the

healthy loan syndications, these investors have positioned themselves somewhat as wolves in sheep's clothing. It is not difficult to understand why many of these funds have been described as "vulture investors."

Credit-oriented hedge funds would argue that their primary business is capturing the return on these loans of 250 to 650 basis points, without the need for a restructuring event. However, the compensation structure of these funds makes this argument much less believable. Hedge fund managers typically receive a management fee of 1% to 2% and share in the investment returns over a target level well above 600 basis points. Assuming the CLO investment is leveraged, the hedge fund is still highly motivated to maximize the return on investment. CLO structures have a waterfall of payments that are first pledged to pay off the related portfolio senior financing in a structured vehicle, with the remainder paid to the subordinated and equity tranches, which is typically where the credit-oriented hedge fund invests[4]. Here there is an acceptable economic justification for investing in these structures, as long as you can fund the portfolio cheaply in the structured debt markets and stay in compliance with covenants. Nevertheless, the big payoff at the equity tranche typically comes from the restructuring of distressed debt in the portfolio.

Most CLOs have minimum credit quality covenants tied to ratings agencies as well as minimum spread covenants, ensuring a cushion between the interest and fee payments into the structure and the interest payments paid to the senior funding tranches. Consequently, many CLOs are driven to sell problem loans if an overall portfolio begins to deteriorate and the covenant levels are threatened. CLOs can sell the problem loans to affiliated hedge funds prior to a restructuring, effectively improving the credit quality of the CLO portfolio and helping the spread, assuming the proceeds are reinvested in interest generating loans, but limiting the overall return to the CLO.

These distressed investor CLOs are creating a vast footprint of potential "loan-to-own" plays that may end up financial home runs for the related hedge funds. In the meantime, they are more than able to cover their operating costs and produce an equity return from the same portfolio. Furthermore, the ability of leveraged loan syndications desks to structure deals without a high-yield component, using second-lien paper, has allowed these investors to move further down-market into true middle-market transactions. Once a borrower gets into trouble, the vulture investors may start demanding additional compensation and other volatile actions, helping to push the company down a slippery slope towards a restructuring. At some point, the regulated banks will likely want out. The distressed investors are then able to increase their ownership and negotiating power while lowering their average cost. Management and private equity are typically overwhelmed by operational issues and quickly get steamrolled in the process.

UNDER THE RADAR

This is not an indictment of the entire institutional investor class. Certainly, there are firms that can make a decent return on lending at these rates – ones that do not have related hedge funds with portfolio companies acquired through this loan-to-own process. Regardless, these transactions are happening all the time and typically stay under the newswire radar. Because the

target firms are already considered distressed, it is easy to believe that a third-party contrarian investor is buying something that nobody else wants.

With the explosion of second lien financing over the past four years, one would be hard-pressed to find a leveraged loan transaction today that did not have a significant level of this credit-oriented hedge fund debt. Because there is so much competition in the leveraged finance and private equity marketplace, most syndicating banks and sponsors are not overly selective regarding the parties involved in their financing. This also has its advantages. Many private equity firms have recently completed dividend recapitalizations that were financed largely with Term Loan B and second lien paper. Banks have historically shied away from transactions that had a significant non-productive use of funds. Thus, many of these transactions could not have been accomplished without institutional lenders who are willing to take on this incremental risk.

It is clear that during the next distressed debt cycle, which will likely turn this year or in early 2007, these distressed investors will continue to push this model. It appears that the biggest losers will be commercial banks and private equity firms, the parties that have so far embraced the involvement of these players in leveraged financings.

WHAT TO DO?

So, what is a middle-market management team and/or equity sponsor to do once these lenders try to get involved in a transaction? First, do not assume that your agent bank is always looking out for your best interest. Unfortunately, the most important issue to syndicating agents is league table credit, and the faster they can fill out a syndication, the better. You may have to become very involved in the process, not something agent bankers typically encourage. Nevertheless, it is critical to conduct due diligence on each of the lenders that have been invited into a transaction. Those investors tied to loan-to-own private equity portfolios should not be immediately rewarded with a key to the henhouse.

This is also important relative to negotiating covenant levels in the loan documents. You should assume that there will be little wiggle room with these distress-oriented institutional lenders if and when covenants are breached. Therefore, covenants should be set based on realistic levels, not just tied to financial projections. Once a transaction begins to deteriorate, it is important for the company to bring in advisors sooner instead of later. A good financial advisor, with enough lead-time, can create multiple potential recovery options and keep the process from heading for a “free fall” and thus, playing into the hands of the vultures.

Also, remember that hedge funds can play a key role in middle-market financing. Much of the hedge fund activity in the middle market was initiated in the post-Enron environment; however, for more than a year now, there have been limited investment opportunities for distressed middle-market transactions. This has led to hedge funds entering the middle-market lending and private equity opportunities, competing with traditional mezzanine and SBIC lenders. Hedge funds offer the advantage of liquidity and speed. Formerly, middle-market companies approached their primary banks for a senior credit facility, a mezzanine lender for a junior or second lien position and a separate equity investor for the long-term growth or acquisition

capital. Management was confronted with numerous investment committees, constant time delays, numerous diligence reviews from constituencies, and constant fear of the "deal blowup" from the long negotiations of the inter-creditor agreements. Hedge funds can now offer middle-market management a one-stop shop, originating the entire capital structure in an expedited timeframe.

CONCLUSION

As we await the next turn in the credit cycle, there is good news and bad news associated with today's capital markets. The good news is there is more capital than ever available across the capital structure, and most deals that make any economic sense at all will get done. The bad news is that within these leveraged capital structures potentially sits vulture investors, just waiting for their chance to make a play that will allow them to take control of a distressed company. Those in middle-market management should especially keep both sides of the situation in mind.

Jay Krasoff is Managing Director of Chiron Financial Group and a member of the Houston chapter of the Turnaround Management Association. jkrasoff@chironfinance.com John O'Neill is President of Tartarus Advisors, Inc. in Southlake, Texas and a member of the Dallas Chapter of the Turnaround Management Association. joneill@tartarusadvisors.com

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[1] King James NT, Mt 21:13, Mr 11:17, Lu 19:46 THE ROTHSCHILD DYNASTY (Condensed from "Descent Into Slavery" by Des Griffin, Chapter Five) - http://www.biblebelievers.org.au/slavery.htm

[2] THE ROTHSCHILD DYNASTY (Condensed from "Descent Into Slavery" by Des Griffin, Chapter Five) - http://www.biblebelievers.org.au/slavery.htm

[3] The Vulture Investors, Hilary Rosenberg, Pages 7 and 14

[4] Hedge Funds: An Emerging Force in the Global Credit Markets, Fitch Ratings, Ltd. July 18th, 2005